Supporting Statement for the
Basel II Interagency Supervisory Guidance
(FR 4199; OMB No. 7100-NEW)

Summary

The Board of Governors of the Federal Reserve System, under delegated authority from the Office of Management and Budget (OMB), proposes to implement the Basel II Interagency Supervisory Guidance (FR 4199; OMB No. 7100-NEW). The Paperwork Reduction Act (PRA) classifies reporting, recordkeeping, or disclosure requirements of agency guidance as an "information collection." [1] On February 28, 2007, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC), (the agencies) published proposed guidance in the *Federal Register* for public comment titled "Proposed Supervisory Guidance for Internal Ratings-Based Systems for Credit Risk, Advanced Measurement Approaches for Operational Risk, and the Supervisory Review Process (Pillar 2) Related to Basel II Implementation."[2]

This proposed supervisory guidance would assist financial institutions implementing proposed revisions to the risk-based capital standards in the United States (New Advanced Capital Adequacy Framework or proposed framework). These proposed revisions were published in the *Federal Register* on September 25, 2006 (71 FR 55830) as a notice of proposed rulemaking (NPR or proposed rule). This proposed supervisory guidance provides additional detail for the advanced approaches and the supervisory review process that should help banks satisfy the qualification requirements in the NPR.

The agencies believe that the documentation, prior approvals, and disclosures included in the proposed Internal Ratings Based (IRB) and Advanced Measurement Approaches (AMA) parts of the guidance are directly related to the information collection requirements in the NPR (sections 21, 22, 44, 53, and 71). The agencies also believe that the burden estimates developed for the NPR adequately cover the additional specificity contained in the proposed IRB and AMA guidance. For the proposed Pillar 2 portion of the guidance, the agencies believe that paragraphs 25, 31, 35, 37, and 42 impose new information collection requirements that were beyond the scope of the burden estimates developed for the NPR. The Pillar 2 guidance contains certain documentation or recordkeeping requirements for state member banks and bank holding companies (BHCs).

The Federal Reserve's total annual burden is estimated to be 6,300 hours for the fifteen financial institutions that are likely to be subject to the proposed guidance. The number of respondents includes both institutions for which the Basel II risk-based capital requirements are mandatory and institutions that may be considering opting-in to Basel II. There are no required reporting forms associated with the guidance.

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[1] 44 U.S.C. § 3501 et seq.

[2] (72 FR 9084).

Background and Justification

Section 1831(o) of the FDI Act requires each Federal banking agency to adopt a risk-based capital requirement, which is based on the prompt corrective action framework in that section. The International Lending Supervision Act (ILSA), 12 U.S.C. § 3907(a)(1), mandates that each Federal banking agency require banks to achieve and maintain adequate capital by establishing minimum levels of capital or by other methods that the appropriate federal banking agency may deem appropriate. Section 908 of the ILSA, 12 U.S.C. §3907(b)(3)(C), also directs the Chairman of the Federal Reserve and the Secretary of the Treasury to encourage governments, central banks, and regulatory authorities of other major banking countries to work toward maintaining and, where appropriate, strengthening the capital bases of banking institutions involved in international lending.

Current U.S. risk-based capital requirements are based on an internationally agreed upon framework for capital measurement that was developed by the Basel Committee on Banking Supervision (BCBS) and endorsed by the central-bank governors of the Group of 10 (G–10) Countries in 1988. This international framework (1988 Accord) accomplished several important objectives. It strengthened capital levels at large, internationally active banks and fostered international consistency and coordination. The 1988 Accord also reduced disincentives for banks to hold liquid, low-risk assets. Moreover, by requiring banks to hold capital against off-balance-sheet exposures, the 1988 Accord represented a significant step forward for regulatory capital measurement. Although the 1988 Accord has been a stabilizing force for the international banking system, the world financial system has become increasingly more complex over the past eighteen years. The BCBS has been working for several years to develop a new regulatory capital framework that recognizes new developments in financial products, incorporates advances in risk measurement and management practices, and more precisely assesses capital charges in relation to risk. On April 29, 2003, the BCBS released for public comment a document entitled ''The New Basel Capital Accord'' (Proposed New Accord) that sets forth proposed revisions to the 1988 Accord.

On August 4, 2003, the agencies published an advanced notice of proposed rulemaking (ANPR) in the *Federal Register* to seek public comment on a new risk-based regulatory capital framework. This ANPR was based on the Proposed New Accord. Also, the agencies participated with other members of the BCBS during the development of the New Accord, which was issued in June 2004. The agencies also participated in the BCBS's Fourth Quantitative Impact Study (QIS 4; OMB No. 7100-0303) during the fall and winter of 2004-2005, to better understand the potential impact of the proposed framework on the risk-based capital requirements for banks.

Contemporaneously with the ANPR, the agencies also issued for public comment two proposed supervisory guidance documents relating to the proposed framework.[3] The

[3] See 68 FR 45949 (Aug. 4, 2003).

first proposed 2003 guidance document described supervisory views on the credit risk measurement and management systems that should be implemented by banks that adopt the IRB approach for computing risk-based capital requirements for corporate credit risk exposures. The second proposed 2003 guidance document provided supervisory views on the operational risk measurement and management systems that should be implemented by banks that adopt the AMA for computing risk-based capital requirements for operational risk, including their operational risk management, data elements, and quantification processes. In October 2004, the agencies also issued for public comment proposed supervisory guidance on IRB systems for retail credit risk exposures.[4]

The agencies issued an NPR on September 25, 2006, [5] which sought comment on the New Advanced Capital Adequacy Framework that revises the existing general risk-based capital standards as applied to large, internationally active U.S. banks.[6] The public comment period on the NPR closed on March 26, 2007.[7] The proposed framework would implement Basel II in the United States. As described in the NPR, Basel II sets forth a three-pillar framework encompassing regulatory risk-based capital requirements (Pillar 1); supervisory review of capital adequacy (Pillar 2)[8]; and market discipline through enhanced public disclosures (Pillar 3). The proposed framework outlined in the NPR for Pillar 1 would require some and permit other qualifying banks to calculate their regulatory risk-based capital requirements using the IRB approach for credit risk and the AMA for operational risk.[9] The NPR also requires a process for the supervisory review of capital adequacy under Pillar 2, and outlines requirements for enhanced public disclosures under Pillar 3. The NPR describes the qualification process and provides qualification requirements for obtaining supervisory approval for use of the advanced approaches.[10] The qualification requirements are written broadly to accommodate the many ways a bank may design and implement robust credit and operational risk measurement and management systems, and to permit industry practice to evolve.

The proposed supervisory guidance documents are companion guidance to the September 2006 NPR and, as such, are designed to be consistent with the proposed rule.

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[4] See 69 FR 62748 (Oct. 27, 2004), and 70 FR 423 (Jan. 4, 2005) (correction).
[5] See 71 FR 55830 (Sept. 25, 2006).
[6] For simplicity, and unless otherwise noted, the term "banks" is used here to refer to banks, savings associations, and bank holding companies. The terms “bank holding company” and “BHC” refer only to bank holding companies regulated by the Board and do not include savings and loan holding companies regulated by the OTS. For a detailed description of the institutions covered by this notice, refer to part I, section 1, of the NPR.
[7] See 71 FR 77518 (Dec. 26, 2006).
[8] The process of supervisory review described in this document reflects a continuation of the longstanding approach employed by the agencies in their supervision of banking institutions. For example, the Federal Reserve introduced in 1999 expectations for certain large, complex banking organizations to develop internal processes for assessing capital adequacy, beyond minimum regulatory capital requirements. See Federal Reserve Supervision and Regulation Letter “Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles,” July 1999.
[9] While Basel II provides several approaches for calculating regulatory risk-based capital requirements under Pillar 1, only the advanced approaches are proposed for implementation in the United States.
[10] See part III, section 22 of the NPR.

They provide additional detail that should help banks satisfy the qualification requirements in the NPR. The agencies believe that the proposed supervisory guidance documents are necessary to supplement the proposed framework with standards to promote safety and soundness and encourage comparability across banks. A bank's primary Federal supervisor will review the bank's framework relative to the qualification requirements in the NPR to determine whether the bank may apply the advanced approaches and has complied with the proposed rule in determining its regulatory capital requirements.

Description of Information Collection

The NPR sets forth a new risk-based regulatory capital adequacy framework that requires certain large or internationally active banks and BHCs to use an internal ratings-based approach to calculate regulatory credit risk capital requirements and advance measurement approaches to calculate regulatory operational risk capital requirements.

A bank would be required to comply with the NPR and the guidance if it meets either of two independent threshold criteria: (i) consolidated total assets of $250 billion or more, as reported on the most recent year-end regulatory reports; or (ii) consolidated total on-balance sheet foreign exposure of $10 billion or more at the most recent year-end. To determine total on-balance sheet foreign exposure, a bank would sum its adjusted cross-border claims, local country claims, and cross-border revaluation gains (calculated in accordance with the Federal Financial Institutions Examination Council (FFIEC) Country Exposure Report (FFIEC 009[11])). Adjusted cross-border claims would equal total cross-border claims less claims with the head office/guarantor located in another country, plus redistributed guaranteed amounts to the country of head office/guarantor. A bank would also be required to comply if it is a subsidiary of another financial institution that uses the advanced approaches.

A BHC would be required to comply with the NPR and the guidance if the BHC has: (i) consolidated total assets (excluding assets held by an insurance underwriting subsidiary) of $250 billion or more, as reported on the most recent year-end regulatory reports; (ii) consolidated total on-balance sheet foreign exposure of $10 billion or more at the most recent year-end; or (iii) a subsidiary depository institution (DI) that is a core bank or opt-in bank. Currently 11 top-tier banking organizations meet these criteria. The agencies note that, using this approach to define whether a BHC is a core bank, it is possible that no single DI under a BHC would meet the threshold criteria, but that all of the BHC's subsidiary DIs would be core banks.

Also, some banks or BHCs may voluntarily decide to adopt the framework. Both mandatory and voluntary respondents would be required to meet certain qualification requirements before they could use the advanced approaches for risk-based capital purposes.

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[11] The Agencies' OMB Control Numbers for the FFIEC 009 are: Federal Reserve (7100-0035), FDIC (3064-0017), and OCC (1557-0100).

The Pillar 2 guidance requires respondents to maintain certain documentation as described in paragraphs 25, 31, 35, 37, and 41 of this portion of the guidance. Details of the requirements for each section are provided below.

Identifying and Measuring Material Risks

Paragraph 25. In considering possible effects of diversification, management should be systematic and rigorous in documenting decisions, and in identifying assumptions used in each level of risk aggregation. Assumptions about diversification should be supported by analysis and evidence. The bank should have systems capable of aggregating risks based on the bank's selected framework. For example, a bank calculating correlations within or among risk types should consider data quality and consistency, and the volatility of correlations over time and under stressed market conditions.

Setting and Assessing Capital Adequacy Goals that Relate to Risk

Paragraph 31. Various definitions of bank capital are used within banking. A bank should state clearly the definition of capital used in any aspect of its internal capital adequacy assessment process (ICAAP). For example, the definition used in models to measure capital adequacy relative to risk may not correspond to capital actually held (available capital resources), and the bank should understand such differences. For internal purposes, some banks may choose a narrow capital definition, such as only common equity, while others may define capital more broadly. Banks should also state explicitly the impact that retained earnings have on capital positions. Since components of capital are not necessarily alike and have varying ability to absorb losses, a bank should thoroughly understand the relationship between its internal capital definition and its assessment of capital adequacy. The bank should document any changes in its internal definition of capital, and the reason for those changes.

Ensuring Integrity of Internal Capital Adequacy Assessments

Paragraph 35. Banks should have complete documentation covering the ICAAP. At a minimum, such documentation should include a description of the overall process, including committees and individuals responsible for the ICAAP, the frequency of ICAAP-related reporting, and procedures for the periodic evaluation of the appropriateness and adequacy of ICAAP. In addition, where applicable, documentation should cover all aspects ordinarily expected for sound use of quantitative methods, including model selection, limitations, data selection and maintenance, controls, and validation.

Paragraph 37. The board of directors and senior management have certain responsibilities in developing, implementing, and overseeing an ICAAP. The board or its appropriately delegated agent should approve the ICAAP and its components, review them on a regular basis, and approve any revisions. That review should encompass the effectiveness of the ICAAP, the appropriateness of risk tolerance levels and capital planning, and the strength of control infrastructures. Senior management should continually ensure that the ICAAP is functioning effectively and as intended; considerations by senior management should be explicit, formal, and documented. Additionally, internal audit should play a key role in the controls and governance surrounding an ICAAP on an ongoing basis.

Paragraph 41. As part of the ICAAP, the board or its delegated agent, as well as appropriate senior management, should periodically review the resulting assessment of overall capital adequacy and determine that actual capital held is consistent with the risk appetite of the bank, taking into account all material risks. This review should include an analysis of how measures of internal capital adequacy compare with other capital measures (such as regulatory, accounting-based or market-determined). The review should also result in formal procedures to correct any deficiencies uncovered in the assessment process, especially if capital is not consistent with the risk profile or risk appetite of the bank.

Time Schedule for Information Collection

Because the documentation required by the guidance is a recordkeeping requirement, copies of the documentation are not collected by the Federal Reserve System and are not published. These recordkeeping requirements are documented on occasion. Bank examiners would verify compliance with this recordkeeping requirement during examinations of state member banks and BHCs.

Sensitive Questions

This collection of information contains no questions of a sensitive nature, as defined by OMB guidelines.

Consultation Outside the Agency

On February 28, 2007, the agencies published the guidance in the *Federal Register* (72 FR 9084) to seek public comment. The comment period for this notice expired on May 29, 2007. The agencies received sixteen comments from banks, BHCs, and trade associations.

Legal Status

The Board's Legal Division has determined that 12 U.S.C. 324 and 12 U.S.C. 1844 (c) authorize the Board to require the information collection. If an institution considers the information to be trade secrets and/or privileged such information could be withheld from the public under the authority of the Freedom of Information Act, 5 U.S.C. 552(b)(4). Additionally, to the extent that such information may be contained in an examination report such information maybe also be withheld from the public, 5 U.S.C. 552 (b)(8).

Estimate of Respondent Burden

The total annual burden for the Pillar 2 portion of the guidance is 6,300 hours, as shown in the table below. The Federal Reserve estimates that it will take each respondent 420 hours to complete the documentation requirements, which is approximately 50 percent of the hours allocated to documentation for the Pillar 1 requirements in the NPR. This burden represents less than 1 percent of the total Federal Reserve System paperwork burden.

	Number of respondents	*Estimated annual frequency*	*Estimated response time*	*Estimated annual burden hours*
FR 4199	15	1	420 hours	6,300

Based on a rate of $100 per hour, the estimated cost to the public for this information collection is $630,000[12].

Estimate of Cost to the Federal Reserve System

Estimates of cost to the Federal Reserve System will be obtained.

[12] Total cost to the public was estimated using the following formula. Percent of staff time, multiplied by annual burden hours, multiplied by hourly rate: 100% Senior Management @ $100. This hourly rate estimate is an average using data from the Bureau of Labor and Statistics, *Occupational Employment and Wages*, news release."